WENDY ALDRED

THE COMPANY DIRECTOR'S DUTY OF CARE AND THE BOUNDS OF BUSINESS JUDGMENT

LLM RESEARCH PAPER

LAW OF BODIES CORPORATE
AND UNINCORPORATE(LAWS 523)

LAW FACULTY
VICTORIA UNIVERSITY OF WELLINGTON

1994

TI

WENDY ALDRED

THE COMPANY DIRECTOR'S DUTY OF CARE AND THE BOUNDS OF BUSINESS JUDGMENT

LLM RESEARCH PAPER

LAW OF BODIES CORPORATE
AND UNINCORPORATE(LAWS 523)

LAW FACULTY
VICTORIA UNIVERSITY OF WELLINGTON

1994

I INTRODUCTION

The business judgment rule is a reflection of the reluctance of the North American judiciary to interfere in corporate decision making. It is now of particular interest to the New Zealand lawyer and legal academic, in the scramble to predict the extent to which the 1993 Companies Act will bring the infrastructure of New Zealand's corporate law closer to its American counterpart.

There is an extensive body of US literature on the business judgment rule, and a great deal of critical divergence as to what the content of the rule is, in what situations it applies, and whether it is a desirable feature of the law of corporations. The rule has been viewed by some commentators as allowing management to escape liability for the consequences of their bad decisions and encouraging laxity,[1] while others consider it to be conducive to necessary risk-taking and economic efficiency.[2] Still others see the rule as merely "meaningless verbiage", arguing that it adds nothing to the pre-existing fiduciary duties of loyalty and care.[3] The business judgment rule has been defined by the Delaware Supreme Court as

> ... a presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company. Absent an abuse of discretion, that judgment will be respected by the courts. The burden is on the party challenging the decision to establish facts rebutting the presumption.[4]

The rule is viewed by the judiciary as providing company directors with a necessary safe-harbour from the judgements made by others possessed of the benefit of hindsight. The leading cases on the modern business judgment rule have been those of the Delaware courts, traditionally regarded as having

1 See Cary "Federalism and Corporate Law: Reflections Upon Delaware" (1974) 88 Yale LJ 663.

2 Eaterbrook and Fischel: idea that the market is a more effective and efficient regulator of corporate action than liabilty rules:

3 See Gevurtz "The Business Judgment Rule: Meaningless Verbiage or Misguided Notion?" (1994) 67 Southern California LR 287.

4 *Aronson* v *Lewis* (1984) A 2d 805.

fostered a jurisprudence indulgent of the interests of management.[5] The rule is not new to US corporate law, and one commentator[6] has traced its origin back as far as the 1829 case of *Percy* v *Millaudon*, wherein it was said that

> the occurrence of difficulties... which offer only a choice of measures, the adoption of a course from which loss ensues cannot make the director responsible, if the error was one one into which a prudent man might have fallen. The contrary doctrine seems to us to suppose the possession, and require the exercise of perfect wisdom in fallible beings. No man would undertake to render a service to another on such severe conditions... The test of responsibility, therefore, should be, not the certainty of wisdom in others, but the possession of ordinary knowledge; and by showing that the error of the [director] is of so gross a kind that a man of common sense, and ordinary attention, would not have fallen into it.[7]

The relationship between the business judgment rule and the standard of care required of directors is much-debated. In Delaware this case law standard is said to be the standard of "the ordinarily careful and prudent person", reflecting the objective tort law standard of reasonableness. The courts have formulated the business judgment rule to reflect their recognition of the inappropriateness of imposing such an objective standard on corporate decision makers, so that even if a decision taken by a director was one which would not have been made by an ordinarily prudent person, it will be protected by the business judgment rule, providing the requirements of sufficient information, good faith and honesty are satisfied.[8]

The rule has been said to act "as both a procedural guide for litigants and a substantive rule of law".[9] In its procedural form, the rule has often been

---

5 The state of Delaware is regarded as the home of the business judgment rule. The minimalist approach of the Delaware courts and state legislature to the regulation of corporate behaviour has made it the principal player in the competition among states for incorporations. Over 40% of New York Stock Exchange companies are incorporated in Delaware.

6 Block, Radin, Barton (eds) *The Business Judgment Rule: Fiduciary Duties of Corporate Directors* (4ed, Weil, Gotshal and Manges, New York, 1993).

7 8. Mart. (n.s.) 68 (La. 1829).

8 For a fuller discussion of the interaction between the business judgment rule and the duty of care, see below, Part III, ?.

9 Balotti and Hanks "Rejudging the business judgment rule"(1993) 48 Business Lawyer 1337.

described as having the effect of a presumption.[10] A court will presume that defendant directors have made a business judgment based on sufficient information, in good faith, and not out of self-interest. There is an onus on the party challenging the decision to establish that one or more of these elements is lacking. If the plaintiff can do so, then the directors will be denied the protection afforded by the rule, and the court may legitimately conduct an investigation into the merits of their actions. If the plaintiff is unable to discharge this burden, then the "substantive" aspect of the business judgment rule will come into play and will preclude the court from superimposing its own judgment on that of the directors.

This paper will give an overview of the way in which the business judgment rule operates in American law, and discuss the differing views as to its utility and propriety. It will then seek to compare the US position with the traditional approach of the commonwealth courts to the issue of when shareholders in a company should be able to challenge the decisions of management, and conclude as to whether the business judgment rule is present (albeit implicitly) in commonwealth law. Finally, the impact of the recent companies legislation upon directors' duties and the question of whether the new Companies Act introduces a "somewhat scattered business judgment rule"[11] will be addressed.2

II THE RATIONALE OF THE BUSINESS JUDGMENT RULE

A The difficulty of assessing corporate decisions

The difficulty of evaluating business decisions in comparison with decisions made in other professional contexts is frequently cited as a justification for the rule. It is said that business decisions are "unique, heavily intuitive and judgmental",[12] and that this renders them less suitable to review in hindsight:

> after-the-fact litigation is a most imperfect device to evaluate corporate decisions. The circumstances surrounding a corporate decision are not easily reconstructed in a courtroom years later, since business imperatives often call for quick decisions, inevitably based on less-than-perfect information. The entrepreneur's function is to encounter risks and to confront uncertainty, and a reasoned

---

10 see the formulation in *Aronson*, above, p.1

11 Hodder, NZ Law Society Seminar *Company Law I - Getting Started* (1993).

12 Gevurtz 308.

> decision at the time may seem a wild hunch viewed years later against a background of perfect knowledge.[13]

Therefore, it is said that business decisions are more difficult to assess than the decisions routinely made by other professionals, such as medical professionals or solicitors, and that "there can be no objective standard by which the correctness of every corporate decision may be measured, by the courts or otherwise.."[14]

In addition to this perceived difficulty, it is often argued that the courts are ill-equipped and infrequently called-upon to evaluate business decisions.[15] In American civil law questions of law are decided by the court, and questions of fact (including whether certain conduct can be said to be negligent) are left to the jury. Whereas a jury of laypeople might be competent to assess whether a motor vehicle has been driven negligently, or even whether a building has been negligently constructed, it is unlikely that they will be able to judge the conduct of a board of directors with comparable ease or accuracy:

> [a] negligent transgression presupposes a departure from normal behaviour. The whole concept of negligence and of 'reasonable man' presupposes as a predicate a clear conception of *what* the person is doing, and a community understanding of a standard of normalcy about *how* he should do it. *Both those pieces are missing in the case of the work of corporate directors.*[16]

Therefore, the business judgment rule imposes a presumption of good faith, disinterest and an honest belief that the action taken was in the company's best interests which must be overcome before a jury will be permitted to deal with the question of whether a board of directors has acted "negligently".

B *The inefficiency of litigation as a regulator of corporate behaviour*

The business judgment rule may also be supported by reference to the economic argument that the market is at least as effective a regulator of management as the rules for liability of company directors. The interests of

---

13 *Joy* v *North* 692 F 2d 880 (2d Cir 1982).

14 *Auerbach* v *Bennett* 393 NE 2d 994.

15 Above n??, 1000.

16 Manning, "The Business Judgment Rule and the Director's Duty of Attention: Time for Reality" (1984) 39 Bus Law 1477, 1494 (emphasis in original).

shareholders and directors often coincide, as generally, both are concerned to maximise the wealth of the corporation.

Shareholders will invest in corporations in the expectation of making money through the increasing market value of their shares, whilst directors must manage the company in such a way that it will attract the injection of futher capital. Some writers have argued that the company directors' security of employment is linked to their competent management of the company, as failure to run a company efficiently will lead to a decline in share prices, and increase the likelihood of the company becoming the target of a takeover bid. Therefore, argue Easterbrook and Fischel, the liability rules are not required to operate as an effective deterrent to bad business decisions except in the case of "large, one-shot frauds", as "managers' personal gains from negligent conduct are small, making the costs they bear without regard to the liability system quite sufficient".[17]

It has also been suggested that incompetent directors may be removed pursuant to a resolution of the shareholders, as powers of appointment and dismissal of a board belong to the shareholders.

C *The necessity of corporate risk-taking*

Traditionally, analogies tended to be drawn by courts and writers between directors and trustees. Both were termed fiduciaries, and held to owe similar duties to the shareholders/beneficiaries whose interests they represented. The modern director, however, is commonly recognised as requiring more freedom to act than the trustee, as the purposes of companies and trusts are quite different.

The company is essentially a device for maximising the wealth of its owners, and in order to profit and expand, it will be necessary for the directors of a company to take some risks. Investors in the sharemarket are aware that their funds will be less secure if they decide to invest in a company rather than a bank, but they freely choose to buy shares, in the expectation that they will make more money. Additionally, under the US disclosure rules, a perspective shareholder will be in a position to obtain a relatively large amount of

17 *The Economic Structure of Corporate Law* (Harvard University Press, Massachusetts, 1991) 98.

information about a company and its management, and will have some degree of knowledge about the modus operandi of the directors of the company before deciding to purchase some of its shares.

III THE OPERATION OF THE BUSINESS JUDGMENT RULE IN US JURISDICTIONS

A. *Defining the business judgment rule*

Several commentators have alluded to the problems one encounters in attempting to define exactly what the business judgment rule is and the nature of its relationship with the duty of care.

The traditional Delaware version of the rule is that cited above in *Aronson* v *Lewis*,[18] where the rule is phrased as a presumption which the plaintiff must overcome before a court will examine the merits of a decision and apply the objective standard of care of the reasonably prudent person. In other US formulations the business judgment rule is simply subsumed into the duty of care itself. Section 4.01(a) of the American Law Institute's *Principles of Corporate Governance* affirms that the standard of care for directors is that of the "ordinarily prudent person... in a like position and under similar circumstances", and Section 4.01(c) which contains the ALI's version of the business judgment rule simply provides that "[a] director... who makes a business judgment in good faith *fulfils his duty under this section*" provided that the director:

> (1) is not interested in the subject of the business judgment;
>
> (2) is informed with respect to the subject of the business judgment to the extent the director reasonably believes to be appropriate under the circumstances; and
>
> (3) rationally believes that the business judgment is in the best interests of the corporation.

This is a somewhat unorthodox version of the rule. The two principal peculiarities are that the rule is not framed as a presumption,[19] and that the

---

18 See above, Part I.

19 The significance of framing the rule as a presumption is discussed belo, Part III,?

usual requirement of an *honest* belief that the action taken is in the company's best interests is replaced by a requrement of a *rational* belief. The latter of these has been criticised as allowing a plaintiff more latitude than under the traditional formulation of the business judgment rule, as the term "rational" imports a degree of objectivity into the test, which is precisely what the courts, in developing the rule, sought to avoid. The Official Comment to the draft defines "rational" as being more permissive than "reasonable", but not precluding judicial inquiry into decisions which are "so removed from the realm of reason... that liability should be incurred".[20] Therefore, the drafters of the section argue, the "rational basis" requirement is supported by the case law which denies the business judgment rule's protection to directors who have acted egregiously or irrationally.[21] One would imagine that this explanation should make the ALI's formulation more palatable to those who prefer the more traditional version of the rule, yet critics warn that

> the effect of the 'rational basis' will be to invite plaintiffs to draw courts into judicial review of business decisions in order to determine whether they had a 'rational basis' - review which the business judgment rule was designed to avoid in the first place.[22]

Additionally, critics believe that it would be possible for a court to read the "rationality" requirement in conjunction with the objective standard of care in §4.01(a) and impose personal liability on directors on the basis of ordinary negligence, an outcome which is expressly precluded by the application of the Delaware formulation of the business judgment rule.[23]

The uncertain status of the rule is exemplified by its complete omission from the Revised Model Business Corporation Act, in favour of leaving the rule to case law. One of the framers of the Act commented that

> [o]ver the past three years [the American Bar Association's Committee on Corporate Laws] has been engaged in an overall

---

20 Comment (d) to § 4.01 of the *Principles.*

21 See below, Part III??

22 Manning 1497

23 The likelihood of such a result is arguably enhanced by the fact that § 8.30 of the Revised Model Business Corporation Act restates the standard of care as that which an ordinary person would exercise under similar circumastances, and requires a director to act in good faith and in a manner she reasonably believes to be in the best interests of the corporation, but contains no business judgment rule.

> revamping of the entire Model Act. In the course of that exercise, the committee tried... to grapple with the elements of the business judgement rule in new section 8.30. After no less than ten drafts and literally hundreds of man-hours of struggle, the effort was... abandoned, and it was decided, *faute de mieux,* to retain [the old language], and seek to go no further.

In addition to the problems experienced by those who have attempted to formulate a statuory model for the duty of care and the business judgment rule, the problems of defining the business judgment rule is exacerbated by a lack of consistency between the various US jurisdictions. Although the remainder of this dicussion will generally be based upon the business judgment rule as expounded by the Delaware courts, it should be pointed out that courts in various jurisdictions have developed and applied their own particular and disparate versions of the rule.

An example of the New York courts' approach to the area is provided by the case of *Kamin* v *American Express Co.*[24] This action arose from an allegation by a minority shareholder that a certain dividend declared by the directors of the American Express Company amounted to waste of a corporate asset.

The company had owned shares in another corporation ("DLJ") which had significantly decreased in value. The board of direcytors declared a dividend pursuant to which it distributed its DLJ shares to its own shareholders. The plaintiff (a minority shareholder in Amex) contended that the preferable course would have been to sell those shares on the stockmarket. If this course had been adopted, the plaintiff alleged, the company would have sustained a $25 million capital loss which would have resulted in income tax savings to the company of $8 million. The defendant directors sought a pre-trial order dismissing the complaint for failure to state a cause of action, or alternatively, for summary judgment.

The response of the court was that in general terms, directors will only be held personally liable for the consequences of their business decisions where the plaintiff can point to facts which indicate the existence of some fraud, bad dealing, bad faith or oppressive conduct. In this case, none of the above were alleged: the plaintiff merely contended that the directors had not chosen the

---

24 383 NYS 2d 807 (1976).

most beneficial course of action. Such an allegation, the court said, gives rise ro no cognizable cause of action:

> the directors' room, rather than the courtroom is the appropriate forum for thrashing out purely business questions which will have an impact on profits, market prices, competitive situations or tax advantages.

More specifically, the court said that the question of whether or not a dividend is to be declared is exclusively a matter of business judgment for the board of directors, and will not be interfered with by a court unless the plaintiff can show something more than imprudence or mistaken judgment.

Additionally, the court considered that the directors' decision was not an ill-considered one. The directors were fully aware of the the fact that a sale (rather than a distribution) of the DLJ shares might have led to a tax saving, but had decided that the benefits of such a sale were outweighed by the likely adverse consequences: the loss of $25 million would have had a severely detrimental effect on the net income figures in the Amex financial statement.

In granting the defendant's motion to dismiss the complaint for failure to state a cause of action, the court summarised the situation, saying that

> what we have here... is that a disagreement exists between two minority shareholders and a unanimous Board of Directors as to the best way to handle a loss already incurred on an investment. The directors are entitled to exercise their honest business judgment on the information before them, and to act within their corporate powers.

B *The business judgment rule and the duty of care*

Perhaps the most confusing aspect of the business judgment rule is its relationship with the duty and standard of care. The application of the rule will preclude further judicial inquiry into the merits of a business decision where the only breach of duty alleged is ordinary negligence on the part of the directors. Therefore, judicial and academic references to the standard of the "ordinarily prudent person" would seem to be misleading.

In reality, the situation is fairly clear: the standard of care is intended as a standard to which directors are expected to conform,[25] but if a director has not exercised due care in making a business decision, she will not necessarily be held personally liable for any loss which results from her lack of care. Such liability will attach only where the breach of duty alleged in proceedings against a director is of a kind which will overcome the business judgment rule's presumption of good faith, disinterest, honest belief that the action taken was in the best interests of the company, sufficient information and no abuse of discretion.

Where a complaint against directors is based upon a breach of the duty of care, and there is no suggestion of a breach of the duty of loyalty, then in order to overcome the presumption in favour of the directors, the plaintiff must allege facts which tend to indicate that the defendant directors acted in breach of the duty to be informed, or that their actions amounted to an abuse of discretion. Both possibilities and their implications for the duty and standard of care will be considered below.

1. *Egregious conduct and the substantive bad decision*

Some business judgment rule dicta implies that in the absence of an allegation in the pleadings of a breach of the duty of loyalty, a plaintiff will never succeed in having the merits of a business decision by the board reviewed by a jury.[26] This is not the case, as the courts have frequently recognised that where a business decision is, on its face, so "egregious or irrational"[27] or exhibits a "reckless indifference to or a deliberate disregard of the stockholders",[28] then the business judgment rule has no application. Such conduct will, in fact, be treated as constructive bad faith.[29] In *Citron* v *Fairchild Camera and Instrument Corp.*, the court explained that "there may be instances in which an apparently interested board makes a judgment that is essentially

---

25 Block et al 52-53.

26 See, for example, *Leslie* v *Lorillard* 18 NE 363, 365; also Kamin (see above note?????).

27 *Citron* v *Fairchild Camera and Instrument Corp* No 6085 slip op 45 (Del Ch 19 May 1988), affirmed 569 A 2d 53 (Del 1989).

28 *Allaun* v *Consolidated Oil* 147 A 257, 261 (Del Ch 1929).

29 Hansen "The Duty of Care, The Business Judgment Rule, and the American Law Institute Corporate Governance Project" (1993) 48 Bus Law 1355, 1365.

inexplicable except on the basis of an otherwise unproven inappropriate motive..."[30]

Although the concepts of egregious conduct and constructive bad faith have been discussed fairly often by courts and writers, there are very few instances of judicial application of the notion that directors who have demonstrated a blatant and extreme lack of due care will not be afforded the protection of the business judgment rule. One of the few examples of such a decision is *Gimbel v The Signal Cos.*,[31] where a minority shareholder sought an injunction to prevent the sale of the corporation's shares in Signal Oil and Gas, its wholly-owned subsidiary, on the ground that the price of $480 million agreed upon was "wholly inadequate". The court considered the circumstances surrounding the transaction, and the process by which the directors had arrived at the decision to sell at the agreed price. It concluded that the procedures followed by the board were not so inadequate that the directors could be said "to have passed an unintelligent and unadvised judgment",[32] but that

> ...the ultimate question is not one of method but of value. The method does not appear so bad on its face as to alter the normal legal principles which control. But the hasty method which produces a dollar result which appears perhaps to be shocking is significant. On the basis of affidavits relating to value, the court has the tentative belief that plaintiff would have a reasonable prospect of success on the merits since limited record indicates a gross disparity between the fair market value of Signal Oil... and what the Board of Directors were willing to sell the company for...[33]

On that basis, the court decided to grant a preliminary injunction restraining the sale, and that a thorough inquiry as to sufficiency of price should be undertaken.

Similar principles will apply in cases of alleged waste of a corporate asset, which, as Hansen points out,[34] may also be considered under the "egregious conduct" exception. Waste will exist where transactions entered into by the board of directors are held to have no corporate purpose, or where a company

---

30 See above note????citron 43-45.

31 316 A 2d 599 (Del Ch 1974).

32 See above note??ibid , 615.

33 ibid 315.

34 Hansen 1365.

asset is transferred at gross undervalue. In seeking to bring a derivative action against a board of directors, a plaintiff shareholder who is unable to state any facts which suggest a breach of the duty of loyalty, is likely to phrase its complaint in terms of lack of corporate purpose[35] or other waste in order to avoid the application of the business judgment rule. The courts have made it plain, however, that further inquiry into the merits of a business decision on the basis of corporate waste will only be sanctioned in extreme circumstances.

In *Aronson* v *Lewis*, the court attempted to introduce some uniformity into these nebulous conceptions of "egregiousness" and "waste" by stating that

> ...to invoke the [business judgment] rule's protection, directors have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them. Having become so informed, they must then act with requisite care in the discharge of their duties. *While the Delaware cases use a variety of terms to describe the applicable standard of care, our analysis satisfies us that under the business judgment rule director liability is predicated upon concepts of gross negligence.*[36]

In summary, then it seems that the interaction between the business judgment rule and the standard of care, is that the existence of the rule means that a plaintiff seeking to challenge a board decision on the basis of a breach of the duty of care (rather than the duty of loyalty) will have to adduce facts which suggest gross negligence on the part of the directors. The gross negligence standard requires either that the challenged decision is, on its face, one which clearly could not have been reached by a rational exercise of business judgment, or the existence of facts which indicate that the defendant directors acted upon insufficient information. The leading Delaware authority on the need for directors to be informed before they can invoke the protections of the business judgment rule is the landmark decision in *Smith* v *Van Gorkom*.[37]

2. *Uninformed decisionmaking*

The decision in *Smith* v *Van Gorkom* that the directors of Trans Union Corp could be found liable for breach of the duty of care on the basis of having

---

35 For example, *Aronson* v *Lewis* 473 A 2d 805 (1984) , plaintiff alleged that the certain terms of an employment agreement between the company and one of its directors "had no valid business purpose" and were "a waste of corporate assets."

36 Aronson 812 (emphasis added).

37 488 A 2d 858 (Del 1985).

entered into a transaction without first having obtained sufficient information, is worthy of discussion, if only because of the controversy it caused, and its statutory and commercial repercussions. For the purposes of this paper, however, the case is important in further elucidating the interplay between the business judgment rule and the notion of "gross negligence".

The Trans Union litigation arose from a decision of the board of directors reached at a special board meeting held on 20 September 1980. Trans Union Corp had been unable to utilise its accumulated investment tax credits, and the market value of its shares had decreased accordingly. The board was involved in discussions as to how this situation might be remedied. Unbeknown to the rest of the board of directors, Jerome W. Van Gorkom, the company's chief executive officer and Chairman of the Board, had held a meeting with Jay Pritzker, a corporate takeover specialist, at which the possible acquisition of Trans Union by Pritzker had been discussed. The agreement they reached was that Pritzker would acquire Trans Union at a price of $55 per share, and additionally, would receive a lock-up option of one million shares at a price of $38 per share (75 cents above the existing market value of the shares). Pritzker required that the Trans Union board reach a decision on the deal within three days of his meeting with Van Gorkom. The day after this meeting, Van Gorkom called a special board meeting for the next day, without advising the directors of the purpose of the meeting.

An hour before the scheduled board meeting, Van Gorkom advised the senior management team of the propsed merger agreement. The reaction of management was decidedly negative. At the board meeting, the chief financial officer told the board that the $55 offer was at the beginnng of the range of fair prices, but that he had only learnt of the proposal that morning, and that rough calculations he had prepared in relation to a possible leveraged buy-out transaction did not provide him with an estimate of the value of the corporation or a fair price for its stock. The board meeting lasted for two hours, and at its conclusion, the directors unanimously approved the merger transaction, and the document (which had been read by none of the directors, including Van Gorkom) was executed by Van Gorkom that night during the interval at the opera. Subsequently, the merger transaction was overwhelmingly approved by the Trans Union shareholders.

The Delaware Court of Chancery found that the directors were shielded from liability by the business judgment rule. In reversing this decision, the

Delaware Supreme Court found that the directors had failed to inform themselves of all reasonably available information relevant to the decision. The court alluded to the the statement in *Aronson,* that "under the business judgment rule, director liability is predicated upon concepts of gross negligence", and said that

> We again confirm that view. We think the concept of gross negligence is also the proper standard for determining whether a business judgment reached by a board of directors was an informed one.[38]

The court went on to say that the directors owed a duty to act in an informed and deliberate manner in determining whether to approve a merger agreement *before* submitting the proposal to the stockholders, and that in the merger context, a director could not abdicate that duty by leaving the decision to the shareholders.

After considering the evidence as to the directors' conduct prior to the conclusion of the agreement, the court found that the directors did not reach an informed business judgment at the September 20 meeting, because (in summary):

> The Directors (1) did not adequately inform themselves as to Van Gorkom's role in forcing the 'sale' of the Company and in establishing the per share purchase price; (2) were uninformed as to the intrinsinc value of the Company; and (3) given these circumstances, at a minimum, were grossly negligent in approving the 'sale' of the Company upon two hours consideration, without prior notice, and without the exigency of a crisis or emergency.[39]

More specifically, it was held that the directors could not invoke the statutory rule in Delaware General Corporation Law § 141 (e) that "directors are fully protected in relying in good faith on reports made by officers", as neither the representations made by Van Gorkom nor the tentative information supplied by the chief financial officer could be said to constitute "reports".[40] Furthermore, the fact that the $55 per share offer was significantly higher than the current market price of $38 was not enough, in the absence of other sound

---

38 Above n 31, 873.

39 Above n 31, 874.

40 Above n 31, 875.

valuation information, to vindicate the board's actions.[41] Additionally, the contention of the directors that the reasonableness of their decision was confirmed by the fact that the acceptance of Pritzker's offer was conditional upon a "market test" was not accepted by the court, as it was found that the board was accorded no real freedom to put the company up for auction.[42] Nor did the directors' impressive cumulative business experience and knowledge of the company come to their aid: the court said that this suggestion was undermined by their unfounded reliance on the premium and the market test.[43]

The court remanded for a new hearing on the determination of damages. Subsequent to the decision, the case was settled, and the Trans Union directors were liable to the extent of the difference between the real value of the corporation which the court arrived at, and the amount for which it was sold.[44]

The case was instantly controversial. Some commentators saw it as a movement (either welcome or unwelcome) away from traditional business judgment rule doctrine, whilst another regarded it as fitting easily "into the mainstream of business judgment rule jurisprudence, with its emphasis not on the merits of the decision made by the directors but on the process by which the decision was made."[45] Alternatively, Macey and Miller argue, the decision can be regarded as peculiarly concerned with the takeover situation, and as a signal to directors faced with a rush offer with a short time fuse that they should not be pressured into accepting such offers, and will not be found liable for failure to accept such an offer within time.[46]

Whether or not the decision in fact was supposed to alter the corporate director's duty of care, it was undoubtedly perceived by most as a message

---

41 Above n 31, 875.

42 Above n 31, 878.

43 Above n 31, 880.

44 This amount was $23.5 million, $10 million of which was covered by the company's insurance policy, and the remainder was paid almost entirely by by the Pritzker group. Kaye (see above, note??) 438, note 65.

45 Manning "Reflections and Practical Tips on Life in the Boardroom After *Van Gorkom*" (1985) 41 Bus Law 1, 4.

46 Macey and Miller "*Trans Union* Reconsidered" (1988) 98 Yale LJ 127.

from the Delaware Supreme court that the process of corporate decisionmaking would be subject to closer judicial scrutiny than had previously been the case.[47] In particular, insurance premiums on D & O liability policies rose, and there was general agreement that directors would have to ensure that the information gathering process undertaken prior to reaching a business decision was thoroughly recorded. The court was, however, clearly concerned to avoid interpretation of the judgment as requiring that directors obtain an investment banker's opinions on every transaction requiring a valuation of the company, recognizing that

> [o]ften insiders familiar with the business of a going concern are in a better position than are outsiders to gather relevant information; and under appropriate circumstances, such directors may be fully protected in relying in good faith upon the valuation reports of their management.[48]

In summary, it seems that the court in *Van Gorkom* was concerned to send a message to corporate directors that they would not be protected by the business judgment rule from the consequences of their bad decisions, where those decisions were not based on sufficient information. The court attempted to describe some guidelines as to what would constitute an acceptable level of information, and stated clearly that the presumption of sufficient information in the business judgment rule would only be overcome where the directors were so uninformed that they could be considered to have acted with gross negligence.

As discussed above[49] it was stated in *Aronson* that the merits of a decision of a board of directors will be challenged by a court only where the decision is, on

---

47 Manning (see above, note 39) 2, suggests that this message might have been a deliberate attempt by the Delaware Supreme Court to demonstrate that the business judgment rule would not protect undeserving directors : he points to the competing tensions with which the court must deal, observing that "As the nation's high court of corporate jurisprudence, it works daily under klieg lights... It must seek to foster a congenial environment for Delaware's leading industry - corporate home-basing. At the same time the court cannot, with professional dignity or long-term priudence, allow Delaware to come to be perceived as the corporate law equivalent of a tax-haven banana republic."

48 Above n 31, 876.

49 473 A 2d 805. See text accompanying n 30.

its face, so egregious or inimical to the interests of the shareholders that it can be labelled "gross negligence". The effect of *Smith* v *Van Gorkom* is to subject the decision making *process* to the same test. The aspect of the case which was regarded as unacceptable by its critics (and the dissenting judges) was not the court's treatment of the law, but rather, the application of the relevant principles to the facts.[50] McNeilly J strongly disagreed with the conclusion reached by the majority, commenting that "the majority opinion reads like an advocate's closing address to a hostile jury".[51] His rebuttal of the majority's conclusion that the directors had been uninformed with respect to the merger proposal was based largely upon the directors' collective business acumen and familiarity with the corporation:

> These men knew Trans Union like the back of their hands and were more than qualified to make on the spot informed business judgments concerning the affairs of Trans Union, including a 100% sale of the corporation. Lest we forget, the corporate world of then and now operates on what is so aptly referred to as "the fast track".[52]

He went on to argue that the directors were "acutely aware of the historical problems facing Trans Union which were caused by the tax laws"[53] and that within two months of the meeting at which the merger proposal was accepted, the board had reviewed and discussed both an outside study of the corporation, and a five-year forecast prepared by management. At the meeting, the company's lawyer was consulted about the proposal, and as a result of his comments, the merger documents were amended to allow Trans Union to accept any better offer which might be made. In McNeilly J's opinion, "this record reveals that the directors acted with the utmost care in informing themselves of the relevant and available facts before passing on the merger."[54]

Additionally, it can be argued that if one aligns the concept of gross negligence with "egregious or irrational conduct", as the court in *Aronson* did, then criticisms of the case are perhaps justified on the ground that the director's conduct, whilst not a model of corporate decision making, was not

---

50 See McNeilly, 897.

51 SMith 893

52 895

53 897

54 897

egregious, nor did it betray a reckless indifference to the shareholders. Nevertheless, the standard clearly enunciated by the court in *Van Gorkom* is that of gross negligence

Having reviewed the possibilities for imposing liability on directors for a breach of the duty of care, it can be observed that the essential effect of the business judgment rule is that it prevents the question of whether a director has acted negligently from *ever* being considered by a jury, provided that the defendant brings a pre-trial motion to dismiss proceedings for failure to state a cause of action, or makes an application for summary judgment. If a plaintiff seeking to bring proceedings against directors on the basis of lack of care cannot establish something more than ordinary negligence, the operation of the business judgment rule will preclude the matter from proceeding to full trial. If, on the other hand, at a depositions hearing it is concluded either that the procedures followed by a board of directors in arriving at a decision were so perfunctory that the directors can be said to have been grossly negligent in the information-gathering process (as in *Van Gorkom*), or that a board decision is so irrational or lacking in corporate purpose on its face that gross negligence can be assumed (as in *Signal*), then the negligence question will already have been decided.

C *The business judgment rule as a presumption*

The Delaware courts and courts applying the laws of at least twenty-one other US jurisdictions,[55]have expressed the business judgment rule as having the effect of a presumption that defendant directors have acted in accordance with their duty of loyalty to the company and that they have acted on sufficient information. However, it is suggested that whether or not the rule is considered to be a presumption will actually be immaterial to the onus of proof.

In Delaware law, a presumption in a civil proceeding imposes "upon the party against whom it is directed the burden of proving that the non-existence of the presumed fact is more probable than its existence".[56] However, in any civil proceeding for negligence, the plaintiff will already bear the burden of proof. Therefore, the business judgment rule's presumption in favour of

---

55 Block et al 13 - 14.

56 Delaware Uniform Rules of Evidence Rule 301(a).

directors would seem to do little more than confirm the need for the plaintiff to plead sufficient facts to raise a doubt that the directors' conduct fell within the usual scope of the business judgment rule.

The business judgment rule provides that a court will not find a director liable for breach of the duty of care, unless it is established that the challenged decision was made on the basis of insufficient information or that it was, on its face, irrational or egregious. If one halts at that point, it can be oserved that in a pretrial motion to dismiss, the defendant's motion will be granted where the plaintiff has not pleaded, with particularity, facts which tend to establish gross negligence. If one goes on to impose a presumption that the directors have not been grossly negligent, that does not alter the situation.

This argument is supported by the contention of Balotti and Hanks that "the term 'presumption' in the early opinions was introduced in its colloquial rather than its evidentiary sense and then carried forward without further consideration."[57] They observe that the existence of the rule itself predates its classification as a presumption by almost a century, and that the effect of the rule on the burden of proof in a shareholder suit for negligence has not been altered following this shift in nomenclature.

D. *Situations of doubtful"disinterest"*

Despite the judicial desire not to inhibit corporate risk-taking and to shelter managerial discretion, courts have recognised that in certain situations there is a particular danger that directors might be motivated by improper considerations, and have been prepared to modify the operation of the business judgment rule accordingly.

1. *Defensive tactics in response to hostile takeover bids*

In the context of corporate takeovers, the Delaware Supreme Court has recognised 'the omnipresent spectre that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders...' [58]

---

57 "Rejudging the Business Judgment Rule" (1993) 48 The Bus Law 1337, 1341.

58 *Unocal Corporation* v *Mesa Petroleum Co.* 493 A. 2d 946 (1985).

The judicial response to this concern has been to impose a slightly higher standard for the application of the business judgment rule. Prior to 1985, Delaware courts would apply the rule only where directors could establish that their sole or primary purpose was something other than protection of their own positions. In 1985, the court in the *Unocal* case[59] introduced a two-pronged test , under which defensive actions would be shielded from judicial inquiry only where

(1) the directors could show that they had reasonable grounds for believing that the takeover bid constituted 'a danger to corporate policy and effectiveness';

and (2) the court independently determined that the defensive action taken was reasonable in relation to the threat posed by the hostile offer.

This method of 'judicial policing' of management decisions in the takeover context has been justified on the ground that one of the bases of the business judgment rule is that corporate practice is regulated to some extent by market forces.[60] If takeovers were able to be fended off by self-interested directors, with no repercussions, then the ability of the market to regulate would be significantly attenuated.[61]

Where the business judgment rule *is* held to apply in these situations, the results can be 'startling'.[62] A general criticism of the business judgment rule is that it tends to shelter directors from liability for idiosyncratic decisions which would have been unlikely to have been made by an ordinarily prudent board of directors. One example of such a decision in the context of takeovers is *Paramount Communications* v *Time Inc.* In that case, Time's directors resisted a takeover bid by Paramount (which involved an offer of $200 per Time share) and borrowed $7-10 billion to merge with another company, Warner Communications. The directors' decision to reject the Paramount offer was accorded the protection of the business judgment rule on the basis that it was made due to the perceived inadequacy of the offer and the Time diectors' concern that Time might lose its identity as a publishing company.

---

59 ibid.

60 see above, p. 2, no.4.

61 Garfield *"Paramount:* the mixed merits of mush" (1992) 17 Delaware Journal of Corporate Law 33.

62 see note 3.

Undoubtedly these reasons would not have greatly impressed the Time shareholders whose shares traded at only $100 each after the Time-Warner merger.

2. *Dismissal of shareholder actions by "independent investigation committees" appointed by defendant directors*

The traditional rule is that the shareholders of a company have only had the right to sue the management of the company where it is alleged that some personal right of the shareholder has been infringed (for example, the shareholder's right to have her name entered on the share register, or the shareholder's right to vote at general meetings). The derivative suit was developed by the equity courts in order to permit the shareholder to sue to enforce a right of the corporation even though her own interests have not been directly adversely affected.[63] The derivative action

> may be viewed as a peculiar type of class action in which the shareholder asserts the right of the corporation for the benefit of all who have an interest in the corporation's success.[64]

The US courts have not, however, smoothed the path of the shareholder who seeks to bring a derivative action. This is in part due to the notion that the proper person to bring an action for a wrong done to the corporation is the corporation itself. It is also due to a perceived high incidence of abuse of the derivative suit by shareholders and lawyers who instigate a derivative action with the objective of profiting personally rather than seeking compensation on behalf of the company as a whole.

A shareholder might bring a derivative suit and, after having instituted proceedings, agree to settle with the corporation for a sum much smaller than that which was sought in the derivative action, but which would ultimately be of greater personal value to the litigating shareholder, as it would be paid directly to the shareholder, in contrast with the payment of the proceeds of a successful derivative action (which would be paid to the corporation itself, and thus would be of only indirect benefit to the individual member). The

---

63 The derivative action was first considered by the Supreme Court in Dodge v Woolsey 18 How 331.

64 Choper, Coffee and Morris, *Cases and Materials on Corporations* (3ed, Little Brown and Co., Boston, 1989) p.786.

vexatious shareholder seeking to pursue such a course is now generally thwarted by the imposition of a requirement that the proceeds of settlement of a derivative suit are now payable to the corporation, and not to the individual who instigates the action. However, these actions are still open to abuse by the attorney who instigates a derivative action in the expectation of a large fee upon settlement or judgment.[65]

Therefore, the derivative action is beset with procedural obstacles for the shareholder. The first requirement is that the shareholder must have exhausted all internal avenues of redress by making a demand on the Board of directors that they take appropriate action to remedy the alleged wrongdoing, or that they take the action in the name of the company. The reason for the courts' insistence on demand is that

> by promoting this form of alternative dispute resolution, rather than immediate recourse to litigation, the demand requirement is a recognition of the fundamental precept that directors manage the business and affairs of corporations.[66]

Where the board of directors includes the directors against whom the aggrieved shareholder seeks to proceed, the general rule is that the demand requrement will be excused on the ground that such a demand would be futile:

> where officers and directors are under an influence which sterilizes their discretion, they cannot be considered proper persons to conduct litigation on behalf of the corporation.[67]

The relationship between the business judgment rule and the demand requirement is basically that the business judgment rule will apply in "demand required cases", but not in cases in which demand will be excused

---

65 See above (Choper etc), p. 786. On the other hand, however, it has been pointed out that

"the derivative action and the disclosure requirements of the securities acts constitute the two major legal bulwarks against managerial self-dealing. The strike suit , in contrast , may very well be no more than an over -the -hill dragon, puffed into life to frighten the courts away from deciding substantive issues..." Cary and Eisenberg Corporations - Cases and Materials (6ed, the Foundation Press, New York, 1988) 613.

66 *Aronson* v *Lewis* 473 A. 2d (Del. 1984), per Moore J.

67 Aronson v Lewis

on the ground of futility due to director interest. In order to avoid such allegations, a common practice is for boards to delegate questions of whether to pursue derivative actions to committees of "independent" directors, usually appointed after the alleged breaches.

The issue which then arises is as to the status of the determination of a "special litigation committee" which, although independent in the sense that its members have had no part in the alleged misconduct, has been appointed by a board including some of the directors named as defendants. The New York and Delaware courts are divided on this question.

The leading New York authority on this point is *Auerbach* v *Bennett*.[68] In response to a request by management, the audit committee of General Telephone and Electronics Co. conducted an investigation into the corporation's international operations, and found that some of the company's board members had been involved in transactions which involved the payment from corporate funds of bribes and kickbacks to public officials and political parties in other countries. Upon the findings of the audit committee being released, Auerbach (a shareholder) instituted a shareholder's derivative action, alleging breaches of duty to the corporation. The board of directors then passed a resolution creating a special litigation committee composed of three disinterested directors who had joined the board shortly after the challenged transactions had occurred. The committee was vested with "all of the authority of the Board of Directors to determine, on behalf of the Board, the position that the Corporation shall take with respect to the derivative claims alleged on its behalf".[69]

The committee found that no proper interest of the corporation or its shareholders would be served by the continued assertion of a claim against it, as the claims asserted were without merit, litigation costs would be inordinately high in view of the unlikelihood of success, the time and talents of senior management would be wasted on lengthy trial and pre-trial proceedings, and the continuing publicity could be damaging to the corporation's interests. The defendants brought a motion for summary judgment on the basis that the determination of the special litigation committee "insulated the first-tier transactions [that is, the alleged breaches]

---

68 393 NE 2d 994.

69 995

from judicial inquiry and was itself subject to the shelter of the business judgment doctrine".[70]

The court reaffirmed the business judgment rule, and stated that

> [d]erivative claims against corporate directors belong to the corporation itself. As with other questions of corporate policy and management, the decision whether to and to what extent to explore and prosecute such claims lies within the judgment and control of the corporation's board of directors. Necessarily such decision must be predicated on the weighing and balancing of a variety of disparate considerations to reach a considered conclusion as to what course of action or inaction is best calculated to protect and advance the interests of the corporation. This is the essence of the responsibility and role of the board of directors, and courts may not intrude to interfere. [71]

In addressing the specific issue of whether the business judgment rule should apply with full force to protect the decision of the litigation committee, the court recognised that it could legitimately inquire as to the disinterested independence of the members of the committee, but rejected the submission of counsel for the plaintiff that any committee authorised by the board of which defendant directors were members must be held to be legally infirm. The basis for this conclusion was that the board of directors had the the exclusive authority on behalf of the company to direct the investigation into the merits of the derivative action, and to decide whether the litigation should be continued, and therefore

> [t]o accept the assertions of the intervenor and to disqualify the entire board would be to render the corporation powerless to make an effective business judgment with respect to the prosecution of the derivative action.

Additionally, the court said that the board could not legitimately abdicate this decision to individuals wholly separate and apart from the board, as delegation of this kind would amount to a breach of "the non-delegable fiduciary duty" owed by the board to the company, its members, employees and creditors.

On these grounds, the court found that the business judgment rule should apply to the determination of the committee and prevent judicial inquiry into

70 996

71 997//

the merits of the decision. This did not, however, preclude the court from assessing the procedures followed by the committee, as

> [p]roof...that the investigation has been so restricted in scope, so shallow in execution, or otherwise so pro forma or halfhearted as to constitute a pretext or sham,...would raise questions of good faith or conceivably fraud which would never be shielded by that doctrine.

The court considered the process by which the committee had reached its decision, and judged it to be adequate, as the committee had engaged special counsel, interviewed all concerned individuals, and sent questionnaires to the corporation's nonmanagement directors. Therefore, the business judgment rule applied to protect the merits of the decision of the special litigation committee, and the motion for summary judgment was granted.

The opposing view was taken by the Delaware Supreme Court in *Zapata Corp. v Maldonado.*[72] As in Auerbach, an independent investigation committee had been created by the board of directors to decide what course of action the corporation should take in respect of the derivative suit. The conditions surrounding its appointment were similar to those in *Auerbach:* its appointor was the whole board of directors. One factor which might distinguish the two cases is that in *Auerbach,* the court noted that the board which appointed the committee was a fifteen member board, and the derivative suit was brought against four of the directors, whilst in *Zapata,* the committee was appointed by a board of directors of which the majority had been named as defendants.

The court discussed the implications of recognising either the legitimacy or impotence of such a committee, weighing the "generally recognized effectiveness [of the derivative suit] as an intra-corporate means of policing boards of directors" against the utility of the committee mechanism as an effective means by which "corporations are [able] to rid themselves of meritless or harmful litigation and strike suits". It decided that the although the "self-interest taint" of the board majority was not a legal bar to the legitimate delegation of the board's power to a group of disinterested directors, the application of the business judgment rule to the determination of the committee was not appropriate:

> [w]e are not satisfied...that acceptance of the "business judgment" rationale at this stage of derivative litigation is a proper balancing

---

72 430 A 2d 779.

> point. While we admit an analogy with a normal case respecting board judgment, it seems to us that there is sufficient risk in the realities of a situation like the one presented in this case to justify caution beyond adherance to the theory of business judgment.

Therefore, the court said, a middle course was appropriate, and the question of what weight to attribute to the findings of a special litigation committee should rest in the independent discretion of the court. The court was content that the factors which must be taken into consideration when deciding whether pursuit of the derivative action would be in the interests of he company "are not beyond the reach of the Court of Chancery which regularly and competently deals with fiduciary relationships, disposition of trust property, approval of settlements and scores of similar problems". A two-step approach to this situation was prescribed. First, the corporation should have the burden of proving independence, good faith, and a reasonable investigation. If the court determines that the corporation has not satisfied this requirement, then it shall deny the corporation's motion to dismiss or for summary judgment. If the court is satisfied of the independence, good faith and sufficient information, then it should go on to apply its own independent business judgment to determine whether or not the motion should be granted. This step requires the corporation to "carefully consider how compelling the corporate interest in dismissal is when faced with a non-frivolous lawsuit" and "should, when appropriate, give special consideration to matters of law and public policy in addition to the corporation's best interests".

IV DIRECTORS' DUTIES AND MANAGERIAL DISCRETION IN COMMONWEALTH LAW

A. *Introduction*

Perhaps the most explicit example of judicial deference to the judgment of company directors is contained in the judgment of Lord Wilberforce in *Howard Smith* v *Ampol Petroleum Ltd*[73]:

---

73 [1974] AC 821. This case concerned the challenge made by a shareholder to the validity of an allotment of shares made by the board of directors. The court held that the allotment was invalid, because although the company was in need of extra capital, the evidence suggested that the primary purpose of the allotment was to alter the nature of the majority shareholding. In reaching this decision, the court emphasised that it would

> [i]t would be wrong for the court to substitute its opinion for that of the management, or indeed to question the correctness of the management's decision, if bona fide arrived at. There is no appeal on the merits from management decisions to courts of law, nor will the courts assume to act as a kind of supervisory board over decisions within the powers of management and honestly arrived at.[7475]

Instances of business judgment rhetoric are apparent throughout commonwealth case law on the powers and duties of corporate directors, but there has been no consistency in terminlogy comparable with the US courts' continued enunciation of the business judgment rule. This may be attributable to the fact that the US courts view the business judgment rule as a procedural safeguard against the unlimited review of complex commercial decisions by juries, whereas although the commonwealth courts recognise the undesirability of judicial review of corporate decisions, there is not the same immediacy to confine these matters to pre-trial proceedings. Additionally, there is a dearth of commonwealth authority on the director's duty of care, which suggests that the traditionally low standard of care applied by the courts has acted as an effective deterrent to prospective shareholder litigants.

Additionally, it is difficult in some respects to make a valid comparison between the US application of the business judgment rule and the duty of care, and the approach of the commonwealth courts to alleged negligence on the part of directors. The standard by which the commonwealth director will be tested will depend upon the method of enforcement which is chosen by an aggrieved shareholder, whereas the American shareholder has only one avenue of redress: the derivative action. Therefore, in order to decide whether NZ corporate law has an implicit business judgment rule , it will be necessary to consider the burden on a plaintiff shareholder who seeks to use any of the available enforcement vehicles, and to compare the common law position of such a shareholder with the likely position under the Companies Act 1993.

B. Oppression actions

---

inquire only into the directors' motives for this action, rather than examining the merits of the decision to make the allotment.

74 Above n 44, 832.

75

Under section 209 of the Companies Act 1955, a shareholder could apply to the court where the company's affairs had been, or were being, or were likely to be conducted in a manner which was oppressive, unfairly discriminatory or unfairly prejudicial to her. In *Thomas v HW Thomas Ltd*[76] a minority shareholder in a closely-held company applied to the court under s209 for an order requiring that the company or some of its members purchase his shares. The plaintiff alleged that the company's conservative policy as to the payment of dividends precluded him from obtaining a proper commercial return on his investment. The Court of Appeal accepted that the company was managed in a very conservative manner. The company was a family business and some of the other shareholders were employees. It relied on internally generated funds to purchase equipment and its only debts were to trade creditors. The dividend payments made by the company had been infrequent and modest. All company decisions were made by the managing director, who was the only director. In holding that the plaintiff was not entitled to a remedy under s209, Richardson J stated that "the question of fairness cannot be assessed in a vacuum or simply from one member's point of view..."[77] More specifically, in rejecting the suggestion of counsel for the plaintiff that the company could cover the cost of purchasing the plaintiff's shares by realising certain assets, he said that

> while there appears to be force in [the] submission that the realisation of the Martin Square yard and the fixed deposit would release ample funds to provide for the purchase of Malcolm Thomas' shares, and that to do so would not prejudice future trading, *that necessarily involves a commercial judgment,* particularly as to the significance of the yard and as to expectations of increases in its capital value in the future...[78]

Sir Thaddeus McCarthy, concurring, added that "... the powers given by s209 are ones which in my view should not be lightly exercised, especially when a lack of
probity or want of good faith is not established".[79]

There are evident similarities between the approach of the New Zealand Court of Appeal in *Thomas,* and that of the New York court in *Kamin* v

76 [1984] 1 NZLR 686.

77 Above n 46, 694.

78 Above n46, 696 (emphasis added).

79 697

American Express Co.[80] The factual similarity between the two cases arises from the suggestion of the respective plaintiffs that the company should have taken some course of action other than that chosen by the board of directors. In *Kamin*, the complainant alleged that instead of distributing the company's shares in another corporation to its shareholders by way of a dividend, the board of directors should have sold those shares on the stockmarket in order to take advantage of the resulting income tax savings. In *Thomas*, the plaintiff's suggestion was that the company should alter its dividend policy in order to provide its shareholders with a proper commercial return on their investment. In both cases, the court clearly stated that questions of whether and in what manner to pay a dividend were matters of business judgment for the board to decide, and that a court would not interpose its own judgment where the plaintiff merely alleged that the directors did not adopt the course of action which was most advantageous to the company. Additionally, both courts recognised that there were competing tensions and interests at work. In *Thomas*, these were the interests of those shareholders who were also employed by the company, and were concerned primarily with its long-term stability, set against the interests of the plaintiff who was more concerned with short-term profit from his investment. In *Kamin*, the court recognised the dichotomy between the tax advantages which might accrue from sale of the shares on the market, and the disadvantages of declaring the $25 million loss in the company's annual financial report.

Both these cases could also be said to represent the traditionally non-interventionist stance preferred by the courts in the specific context of directorial decisions as to payment of dividends. In *Lee* v *Neuchatel Asphalte Co.*,[81] the plaintiff brought an action on behalf of himself and other holders of ordinary shares seeking a court declaration that a certain dividend paid to preference shareholders was paid out of capital and not profit, and an injunction to prevent the distribution of the funds to the shareholders. The basis for this allegation was that the chief asset of the company was a wasting asset (a mine), and that company profits should be returned to the company to compensate for the decrease in capital. In denying the plaintiff a remedy, the court articulated its reasoning in classical "busiuness judgment" terminology, saying that whilst it would have no problem with intervening in a case where the plaintiff could establish the existence of fraudulent or improprer motives

80 See above Kamin

81 (1889) 41 Ch D 1.

> ...if the court sees that the directors have acted fairly and reasonably in ascertaining whether this is a division of profit and not of capital, and then in what is really a matter of internal arrangement (if it is done honestly and does not violate any provisions of the articles) the court is very unwilling to interfere, and...ought not to interfere, with the discretion exercised by the directors, who have the management of the company, or with the powers exercised by the company within the articles.

The derivative action

The derivative action has decreased in popularity since the advent of the action for oppression or conduct unfairly prejudicial, as a plaintiff seeking to bring a derivative action on the company's behalf must overcome a number of procedural barriers. The inaccessibility of the derivative action is due to the traditional adherence of the courts to the principle in *Foss* v *Harbottle:*[82] that in the case of wrong done to a company, the company is the proper plaintiff.

At common law the plaintiff seeking to assert a right of the company against its directors would be permitted to do so only where she could bring the action within the "fraud on the minority" exception to the rule in *Foss* v *Harbottle*. This requirement meant that a plaintiff would have to show

(1) that the breach in respect of which the action is sought to be brought must be one that cannot be ratified by a simple majority of the company in general meeting; and
(2) that the wrongdoers are in control of the company.[83]

The meaning of the word "fraud" in this respect is not entirely clear, although it seems that actual dishonest intent (the traditional common law definition of fraud) is not necessarily required. However, there is authority to the effect that something more than mere negligence is required in order for the derivative action to proceed, as it was held in *Pavlides* v *Jensen*[84] that mere negligence is capable of ratification by the shareholders. In that case, a minority shareholder seeking to bring a derivative action alleged that the

---

82 (1843) Hare 461.

83 Farrar and Russell *Company Law and Securities Regulation in New Zealand* (Butterworths, Wellington, 1985) 262.

84 (1956) 1 Ch 565.

directors had been grossly negligent in selling a corporate asset (an asbestos mine) at undervalue. In dismissing the shareholder's action, Danckwerts J noted that there was no allegation of fraud or ultra vires on the part of the defendant directors, and stated that

> [i]t was open to the company, on the resolution of a majority of the shareholders, to sell the mine at a price decided by the company in that manner, and it was open to the company by a vote of the majority to decide that, if the directors by their negligence or error of judgment had sold the company's mine at an undervalue, proceedings should not be taken by the company against the directors.[85]

Derivative actions which have been permitted to proceed usually concern decisions by directors which are tainted with self-interest. In *Daniels* v *Daniels*,[86] the complaint of the plaintiff shareholder was that in 1970, the directors of the company (a husband and wife who were also the majority shareholders) had sold the company's land to one of the directors (the wife) for £4250, which the directors either knew or should have known to be an inadequate price. Subsequently, the land was resold for £120 000.

Templeman J noted the decision in Pavlides, but observed that neither that case (which dealt solely with negligence) nor the "simple fraud" authorities which allowed a derivative action to proceed were applicable to the case at hand:

> [t]o put up with foolish directors is one thing; to put up with directors who are so foolish that they make a profit of £115 000 odd at the expense of the company is something entirely different.[87]

Once again, the familiar terms of business judgment rhetoric emerge from these English cases, and it seems that the commonwealth courts are conscious of the dangers of allowing a minority shareholder unlimited scope to challenge management decisions. In fact, it is arguable that the commonwealth courts come closest to the business judgment rule in these derivative action cases, where before the action is even permitted to proceed, the complaining shareholder must allege facts which amount to something more than mere negligence. Admittedly, the exact elements of the "fraud on thre minority" requirement have never been unequivocally defined, but the

---

85 ibid 576.

86 [1978] Ch D 406.

87 ibid 414.

cases indicate that elements of self-interest will be enough to satisfy a court that a derivative action should not be thwarted.

Under the 1993 Companies Act, the derivative action is significantly reformed, to completely overcome the theoretical and practical difficulties of the rule in *Foss* v *Harbottle*. The "fraud on the minority" requirement is abolished, and the procedure which a shareholder must follow is set out in section 165 which provides that the court may grant leave to the shareholder to bring an action in the name of the company. The need for a complainant to be granted leave is a recognition of the fact that questions of whether or not to litigate are generally within the domain of the board of directors. Section 165(2) lists the factors which the court shall have regard to when considering an application for leave under s165(1). These are:

(a) The likelihood of the proceedings succeeding:
(b) The costs of the proceedings in relation to the relief likely to be obtained:
(c) Any action already taken by the company or related company to obtain relief:
(d) The interests of the company or related company in the proceedings being commenced, continued, defended, or discontinued, as the case may be.

These factors are instantly identifiable as the types of considerations taken into account by Special Litigation committees in the US when determining whether the corporation should proceed with a derivative suit instituted by a shareholder. This raises the question of what approach a court considering an application for leave should take to the decision of such a committee. Delegation by the board of the authority to make decisions regarding shareholder litigation is permitted under the 1993 Act, as such decisions are not within the s130(1) prohibition on the delegation of certain of the directors' powers (specified in the Second Schedule). The two possible approaches to this issue are provided by the divergent approaches of the Delaware and New York courts.

As discussed above, the central issue in this respect is whether the fact that the alleged wrongdoers are members of the boards of directors which appoint such committees should have any bearing on the approach of the courts to a committee's decision. In *Corporate Law in Canada*,[88] Welling suggests that that Canadian courts, faced with the same dichotomy should adopt the attitude that the opinion of such committees should be treated in a manner similar to the way in which a court views the testimony of an expert witness. He contrasts this with the approach of the New York court in *Auerbach* v *Bennett*,[89] which he considers to "[analogize] the 'special litigation committee' to an administrative tribunal",[90] in refusing to inquire beyond the sufficiency of the procedures followed by the committee.

It is suggested that this view is the correct one, as it recognizes the probability that the directors who comprise the special litigation committee may well be uncomfortable, albeit subconsciously, with the notion of directing that the company proceed against their fellow directors.

The director's standard of care in New Zealand law

Like the US courts, the commonwealth judiciary has recognised that exposure to action for ordinary negligence is more potentially damaging to the corporate director than to other professionals, and likely to make the office an unattractive one. The leading English authority on the director's duties of care, skill and attention is *Re City Equitable Fire Insurance Limited*,[91] and it provides the benchmark for the low standard of care expected of directors. In that case, frauds on the part of the managing director had resulted in significant loss to the corporation. The other directors were clearly not involved in the fraud, and no breach of their duty of loyalty to the company was alleged, but the plaintiff (the receiver in this case) sought to establish that they should be held liable for the loss on the basis that they should have apprehended the fraud and prevented it from occurring.

Romer J found that the directors had not breached the duty of care. He advanced three propositions which have come to represent the common law approach to the duty:

---

88 (2ed, Butterworths, Vancouver, 1991) 533.

89 393 NE 2d 994 (NYCA 1979). See above, part

90 Above n84, 531.

91 [1925] Ch 407.

(1) a director need show no greater degree of skill than may be expected from a person of his/her knowledge and experience;

(2) a director is not bound to give continuous attention to the affairs of her company;

(3) a director is entitled to rely on the advice of officers or experts.

Additionally, stated Romer J, a director will avoid liability for conduct which falls short of "gross and culpable negligence". The meaning of these words is not elucidated in the judgment, and the question of what constitutes gross and culpable negligence has been debated since the case. However, unclear as it might be, this standard has been accepted by the Privy Council[92] and the New Zealand Court of Appeal.[93]

A comparison between the commonwealth law "gross and culpable negligence" standard, and the US requirement of "gross negligence" in order to overcome the business judgment rule reveals that there is little distinction between the standard expected of directors in the two jurisdictions.

It can be seen that there are similarities between the 'business judgment' approach of the American courts and the approach taken by the NZ courts prior to the 1993 Act. It therefore remains to be decided whether section 137 of the new Act has altered the duty of care or whether it leaves room for the similarities with the American approach. At first glance, one would assume that the new legislation would accord with the North American model, given the reference made in the Long Title to "allowing directors a wide discretion in matters of business judgment". However, the position is rendered less certain by the provision in section 137 that

> [a] director of a company, when exercising powers or performing duties as a director, must exercise the care, diligence and skill that a reasonable director would exercise in the same circumstances taking into account, but without limitation,-
>
> (a) The nature of the company; and
>
> (b) The nature of the decision; and
>
> (c) The position of the director and the nature of the responsibilities undertaken by him or her.

92 Kuwait Asia Bank

93 Grayburn v Laing.

It is submitted that since the section provides no clear instruction to the courts to *raise* the standard, it is unlikely that any significant change will occur. As David Jones has pointed out, there is no compelling reason why the 'reasonable director' in the 1993 Act should be held to a higher standard of care than the ordinary person acting on her own behalf in similar circumstances:

> The test is not expressed in terms of 'a reasonably careful director', but in terms of the care of 'a reasonable director'. This could be assessed only in the light of the circumstances pertaining in any particular case because it is impossible to define the model against which the standard is to be measured... The wording of s137 of the 1993 Act, in measuring the care expected of a director 'in the same circumstances' effectively adopts this same standard laid down by Romer J in the *Re City Equitable* case... [94]

Aspects of the business judgment rule are apparent in other sections of the 1993 Act: section 131 restates the directors duty to act in good faith and in the best interests of the company, and a framework for the treatment of transactions involving self-interest is provided in sections 109-115. However, there is no coherent statement of a business judgment rule of general application to support the view that the 1993 Act takes NZ law any closer to the US position than it was under Romer J's statement of the law in *Re City Equitable.*

V CONCLUSION

In the final analysis, it seems that the position of a director faced with a negligence action will be in largely the same position in both the United States and under the common law. Whether something more will be expected under the Companies Act 1993 is unclear at this stage, as the question of whether the words "reasonable director" import any real objectivity into the inquiry awaits judicial clarification. However, if the common law standard is upheld, then it could be said that there is an implicit version of the business judgment rule in New Zealand corporate law. The fact that the New Zealand courts

94 *Company Law in New Zealand: A Guide to the Companies Act 1993* (Butterworths, Wellington, 1993), p.121.

have never spoken in terms of a "presumption" in favour of directors does not preclude the operation of the rule in this jurisdiction, as it has been shown that this classification is in reality, simply a matter of semantics rather than an important evidentiary rule.

BIBLIOGRAPHY

¶ *Texts referred to include:*

1 Block, Radin, Barton (eds) *The Business Judgment Rule: Fiduciary Duties of Corporate Directors* (4ed, Weil, Gotshal, Manges, New York, 1993).

2 Cary and Eisenberg *Corporations - Cases and Materials* (6ed, The Foundation Press, New York, 1988).

3 Casad, Fink and Simon *Civil Procedure - Cases and Materials* (2ed, The Michie Co, Virginia, 1984).

4 Choper, Coffee and Morris *Cases and Materials on Corporations* (3ed, Little, Brown & Co, Boston, 1989).

5 Easterbrook and Fischel *The Economic Structure of Corporate Law* (Harvard University Press, Massachusetts, 1991).

6 Farrar and Russell *Company Law and Securities Regulation in New Zealand* (Butterworths, Wellington, 1985).

7 Jones *Company Law in New Zealand: A Guide to the Companies Act 1993* (Butterworths, Wellington, 1993).

8 Posner and Scott (eds) *The Economics of Corporation Law and Securities Regulation* (Little Brown & Co, Boston, 1980).

9 Romano *Foundations of Corporate Law* (Oxford University Press, New York, 1993).

¶ *Articles referred to include:*

1 Balotti and Hanks "Rejudging the Business Judgment Rule" (1993) Bus Law 1337.

2 Block, Radin and Maimone "Chancellor Allen, the Business Judgment Rule, and the Shareholders' Right to Decide" (1992) 17 Del Journal of Corporate Law 785.

3 Burgman and Cox "Corporate Directors, Corporate Realities and the Deliberative Process: An Analysis of the *Trans Union* Case" (1986) 11 J Corp Law 359.

4 Cary "Federalism and Corporate Law: Reflections Upon Delaware" (1974) 88 Yale LJ 663.

5 De Mott "Directors' Duty of Care and the Business Judgment Rule: American Precedents and Australian Choices" (1992) 4 Bond LR 133.

6 Gevurtz "The Business Judgment Rule: Meaningless Verbiage or Misguided Notion?" (1994) 67 Southern California LR 287.

7 Jones and Manning "Directors - A Statutory Duty of Care and Business Judgment" Accountants Journal Feb 1991, 78.

8 Kaye "Statutory Developments in Directors Liability- State Responses to *Smith* v *Van Gorkom*" Annual Survey of American Law 429.

9 Manning "The Business Judgment Rule and the Directors' Duty of Attention: Time for Reality" (1984) 39 Bus Law 1477.

10 Manning "Reflections and Practical Tips on Life in the Boardroom After *Van Gorkom*" (1985) 41 Bus Law 1.

11 Macey and Miller "*Trans Union* Reconsidered" (1988) 98 Yale LJ 127.